BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 98A-0707
John Manter	)	
	)	
Case ID: 89002463990	)	
	)	

Representing the Parties:

For Appellant:	John Manter
For Respondent:	Richard Gould, Counsel
Counsel for Board of Equalization:	John S. Butterfield, Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19045[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of John Manter against a proposed assessment of additional personal income tax in the amount of $6,476 for the year 1995. The issue

[1]Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

before this Board is whether California-source income of an S corporation, passed-through to a nonresident, is subject to California tax.

Appellant is a resident of the State of Connecticut. During 1995, appellant was a shareholder of Cellular 2000 Telephone Company, Inc., a Delaware corporation. Cellular 2000 was authorized to do business in California, and in 1995 reported that all of its income was sourced in this state. Cellular 2000 elected to be treated as an S corporation for both federal and California tax purposes. For 1995, Cellular 2000 provided appellant with a K-1 which reflected that appellant's distributive share of the corporation's ordinary income for 1995 was $97,491.

Appellant apparently made estimated tax payments to California in the amount of $3,400. Appellant filed a nonresident tax return in which he contended that the distributive share reported to him by Cellular 2000 was not subject to California tax, and claimed a refund of $3,400. Respondent issued the refund requested, but later began a review of appellant's return. Upon review, respondent concluded that appellant was subject to tax on his distributive share of Cellular 2000's California source income and issued its Notice of Proposed Assessment. After protest, respondent affirmed the proposed assessment, and this appeal followed.

Appellant's argument in this case is straightforward. Section 17041, subdivision (b), imposes tax upon the entire taxable income of nonresidents "which is derived from sources in this state." Section 17952 specifies that "income of nonresidents from stocks, bonds, notes or other intangible personal property is not income from sources within this State unless the property has acquired a business situs in this State." In 1976 the California Court of Appeal held that distributions from S corporations were sourced to the domicile of the owner of the stock, under the doctrine of *mobilia sequuntur personam*,[2] and not to where the corporation did business. (Christman v. Franchise Tax Board (1976) 64 Cal.App.3d 751.) This Board reached a similar conclusion in Appeal of Ronnie C. and Patricia S. Childs, decided August 1, 1980 (hereinafter "Childs"). Based on these authorities, appellant submits that his distributive share of Cellular 2000's income is not California-source income; rather, it is sourced to his domicile, i.e., Connecticut. As such, it is not subject to California tax.

Appellant's analysis ignores several developments which occurred after the decisions in Christman and Childs were handed down. In the years prior to 1987, California did not recognize S corporations. However, in 1987 the California Legislature enacted significant new tax legislation. Included in the new legislation were provisions which allowed, for the first time, corporations electing S corporation status for federal purposes to elect such status for California as well. (Rev. & Tax. Code, § 23800 *et seq*.) However, S corporations with nonresident shareholders were required, as a condition

[2] Under this rule, an intangible, such as stock, has its situs in the same state where its owner resides.

of a valid California election, to file with their returns a statement of consent by each nonresident shareholder to be subject to the jurisdiction of the State of California to tax the nonresident shareholder's pro rata share of the corporation's California-source income. (Rev. & Tax. Code, § 23801, subd. (b)(1).)[3] Appellant admits that he signed such a consent. The Legislature also provided for an S corporation to file a composite return on behalf of its nonresident shareholders. (Rev. & Tax. Code, § 18535.)

Appellant argues that the statutory framework set out above does not modify the rule set out in section 17952. In appellant's view, his consent to the state's jurisdiction to tax does not waive the provisions of section 17952. We disagree.

In Isaacson v. Iowa State Tax Commission (1971) 183 N.W.2d 693, the Supreme Court of Iowa dealt with a similar argument. When Iowa conformed to federal S corporation treatment for electing corporations, it did so, as California did in Revenue and Taxation Code section 23800, by making the relevant provisions of the Internal Revenue Code applicable for state purposes. (Iowa Code, § 422.36(5).) Iowa also had a statute, similar to Revenue and Taxation Code section 17952, which allocated certain income from annuities, interest and dividends to a nonresident's domicile. (Iowa Code, § 422.8(2).) The taxpayer, a resident of Nebraska, argued, as appellant does here, that his S corporation distributions were not subject to Iowa tax. The Iowa Supreme Court concluded that interpretation of the interplay between the two statutes required it to ascertain the legislative intent; the court concluded that the legislature intended, by adoption of Iowa Code section 422.36(5), to subject nonresident shareholders of S corporations doing business in Iowa to Iowa tax on the shareholder's distributive share of Iowa source income.

We similarly find that the California Legislature's intent is clear. Not only did the Legislature substantially conform to the Internal Revenue Code regarding the taxation of S corporation shareholders, it also provided for such nonresident shareholders to have tax withheld by the S corporation on California-source income. (See former Rev. & Tax. Code, § 23801, subd. (b)(2), as effective Jan. 1, 1987.) It provided for composite returns to be filed by nonresident shareholders of S corporations doing business in this state. Neither of these provisions would be necessary if S

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[3] It has been suggested that the "consent of nonresident shareholders" requirement was adopted due to a concern by the state that it might lack the constitutional jurisdiction to tax nonresident S corporation shareholders. (See Willson and Windfield-Hansen, *State Taxation of Pass-Through Entities: General Principles*, 1500 T.M., p.1500:0042, 1998.) However, it appears settled that there is no constitutional bar to asserting such tax. (Kulick v. Department of Revenue (1981) 290 Or. 507 [concluding that Oregon had the power to tax S corporation distributions to nonresident shareholders] and Wisconsin v. J.C. Penney Co. (1940) 311 U.S. 435 [concluding that states may require corporations to withhold state tax on dividends paid to nonresident shareholders].)

corporation distributive shares did not constitute income taxable by California. We do not believe that the Legislature enacted those provisions for no purpose.

We take further guidance from the longstanding treatment of partnerships in this state for tax purposes. Partnerships, like S corporations, are "pass-through" entities. Partnership interests are intangible property, just as are shares of an S corporation. Taxation of partners is imposed in California by reference to the corresponding provisions of the Internal Revenue Code. Nonetheless, and despite there being no explicit exemption for partnership intangible interests in section 17952, respondent, by long-standing Regulation has held that pass-through partnership income received by a non-resident is subject to California tax where the source of the partnership's income is in this state. (See 18 Cal. Code of Regulations, §17951-1.)[4] We are confident that the Legislature intended the same rule to apply in the case of S corporations.

The action of respondent is sustained.

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[4] Conversely, income derived from the sale of a partnership interest, and presumably from the sale of S corporation shares, is sourced, under section 17952, to the domicile of the partner or shareholder. (Appeal of Amyas and Evelyn P. Ames, 87-SBE-042, June 17, 1987.)

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of John Manter against a proposed assessment of additional personal income tax in the amount of $6,476 for the year 1995 be and the same is hereby sustained.

Done at Sacramento, California, this 9th day of December, 1999 by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal, Mr. Chiang, Mr. Parrish and Ms. Mandel* present.

Johan Klehs, Chairman

Dean F. Andal, Member

John Chiang, Member

Claude Parrish, Member

Marcy Jo Mandel*, Member

*For Kathleen Connell per government Code section 7.9.

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